

Message Text

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60

ACTION ARA-10

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FM AMEMBASSY BOGOTA

TO SECSTATE WASHDC 5701

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EO 11652: NA

TAGS: EFIN CO

SUBJ: DEVALUATION IS PART OF THE NEW ECONOMIC PACKAGE

1. THE SITUATION: ONE OF THE MORE IMPORTANT ECONOMIC MEASURES UNDERTAKEN THUS FAR BY THE LOPEZ ADMINISTRATION HAS BEEN THE SUBSTANTIAL INCREASE IN THE RATE OF DEVALUATION OF THE PESO. UNLIKE THE OTHER ECONOMIC MEASURES, THE GOVERNMENT NEVER FORMALLY ANNOUNCED THE CHANGE IN EXCHANGE RATE POLICY. UNDOUBTEDLY GOC OFFICIALS BELIEVED THAT ANNOUNCING THIS MEASURE IN ADVANCE WOULD DO MORE HARM THAN GOOD SINCE IT WOULD STIMULATE TEMPORARY CAPITAL FLIGHT. LAST YEAR THE EXCHANGE RATE DEVALUED BY APPROXIMATELY 9 PERCENT. FOR THE FIRST FIVE MONTHS OF THIS YEAR, UP TO THE TIME OF LOPEZ' INAUGURATION, THE EXCHANGE RATE MOVED AT AN ANNUAL RATE OF 6 PERCENT. FOR THE FIRST THREE MONTHS OF THE LOPEZ PRESIDENCY, THE EXCHANGE RATE HAS BEEN DEVALUATING AT AN AVERAGE ANNUAL RATE OF 28 PERCENT. IF THIS RATE CONTINUES FOR THE REST OF THE YEAR WHICH IS LIKELY, WE CAN EXPECT AN ANNUAL OVERALL DEVALUATION OF 14.5 PERCENT.

2. THE STRATEGY: THE STRATEGY BEHIND THE ACCELERATION IN THE RATE OF DEVALUATION REMAINS UNCLEAR. GOVERNMENT OFFICIALS DO NOT DISCUSS THE MOTIVES BEHIND THE NEW EXCHANGE RATE POLICY IN UNCLASSIFIED

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PUBLIC STATEMENTS AND EVEN THE BANKING COMMUNITY IS DIVIDED AS

TO THE RATIONALE AND PROBABLE DURATION OF THIS POLICY. WE BELIEVE IT WAS DESIGNED TO IMPROVE COLOMBIA'S COMPETITIVE POSITION AND IT IS RELATED TO THE GOC DECISION TO SUBSTANTIALLY REDUCE THE GOVERNMENT FINANCED EXPORT INCENTIVE PROGRAM CALLED CAT. AS PART OF ITS GENERAL AUSTERITY PROGRAM THE CAT WAS REDUCED BY 8 PERCENT OF THE VALUE OF EXPORTS FOR A WIDE RANGE OF PRODUCTS. IF YOU ADD THE 8 PERCENT LOST CAT TO THE 6 PERCENT DEVALUATION RATE, WHICH EXISTED BEFORE LOPEZ TOOK OFFICE, YOU COME VERY CLOSE TO THE 14.5 PERCENT OVERALL DEVALUATION WE HAVE PREDICTED FOR THIS YEAR. ONE SHOULD ALSO KEEP IN MIND THAT AN ACCELERATION IN THE RATE OF DEVALUATION TENDS TO MAKE COLOMBIAN EXPORTS MORE COMPETITIVE AND PROVIDES MORE INCOME TO EXPORTERS. HOWEVER, IF ONE ASSUMES THAT COLOMBIAN EXPORT PRICES WILL INCREASE AT ABOUT THE SAME OVERALL INCREASE AS THE CONSUMER PRICE INDEX (ABOUT 24-26 PERCENT THIS YEAR) A DEVALUATION OF 14 PERCENT MAY NOT BE SUFFICIENT IF COLOMBIA WISHES TO MAINTAIN ITS COMPETITIVE POSITION AT A TIME OF UNCERTAINTY IN WORLD COMMODITY MARKETS. MUCH WILL DEPEND ON COMPARATIVE INFLATION RATES AND EXCHANGE RATE POLICIES OF THOSE COUNTRIES WHICH COMPETE WITH COLOMBIA FOR EXPORT MARKETS.

3. THE CRITICISM: THERE HAS BEEN GROWING CRITICISM IN THE FINANCIAL COMMUNITY AGAINST THE ACCELERATION IN THE RATE OF DEVALUATION. IT IS ARGUED THAT THIS POLICY (A) WILL INCREASE COSTS TO EXPORTERS SINCE THEY WILL NOW HAVE TO PAY MORE FOR IMPORTED INPUTS (B) WILL CAUSE FIRMS TO PAY MORE PESOS TO AMORTIZE EXTERNAL LOANS DENOMINATED IN DOLLARS AND (C) WOULD ADD TO INFLATION DOMESTICALLY SINCE IMPORTED PRODUCTS SOLD IN COLOMBIA WILL NOW COST MORE. WHILE IT IS TRUE THAT EXPORT COSTS WILL BE INCREASED SOMEWHAT, DEVALUATION IS ALSO AN INCENTIVE TO PROMOTE IMPORT SUBSTITUTION INSTEAD OF DEPENDING AS HEAVILY ON IMPORTED INPUTS FOR EXPORTS. IT IS TRUE THAT THE BORROWER ABSORBS MOST OF THE EXCHANGE RATE RISK ON FOREIGN LOANS BUT RELATIVELY LOW INTEREST RATES ON FOREIGN LOANS STILL MAKE THEM MORE ATTRACTIVE THAN BORROWING FROM COMMERCIAL SOURCES DOMESTICALLY. ON THE BASIS OF THE BEST INFORMATION WE HAVE FROM THE CENTRAL BANK, THE ACCELERATED RATE OF DEVALUATION IS NOT LIKELY TO CAUSE SIGNIFICANT INCREASED PRESSURE ON DOMESTIC PRICES. THAT IS A 14 PERCENT OVERALL DEVALUATION IS EXPECTED TO ADD ONLY 3 PERCENTAGE POINTS TO THE WHOLESALE PRICE INDEX.

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